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In the Supreme Court of the United States

OCTOBER TERM, 1942.

No. 42.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

WARREN TOOL CORPORATION,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT.

BRIEF FOR THE RESPONDENT.

RAYMOND T. JACKSON,
PAUL W. FRUM,
RAYMOND T. SAWYER, JR.,
C. SHERMAN DYE,
Cleveland, Ohio,
Attorneys for the Taxpayer.

BAKER, HOSTETLER & PATTERSON,
1956 Union Commerce Bldg.,
Cleveland, Ohio,
Of Counsel.

THE GATES LEGAL PUBLISHING CO., CLEVELAND, OHIO—MAIN 5647

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ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT.

BRIEF FOR THE RESPONDENT.

I. OPINION BELOW.

The opinion of the Board of Tax Appeals (Warren,[1] R. 22-23) is not reported. The memorandum opinion of the Sixth Circuit Court of Appeals is reported at 124 F. (2d) 360.

II. JURISDICTION.

The decree of the Circuit Court of Appeals was entered December 9, 1941. (R. 31.) The petition for the writ of certiorari was filed March 5, 1942 and granted April 6, 1942. The jurisdiction of this Court is invoked by the petitioner under Section 240(a) of the Judicial Code as Amended by the Act of February 13, 1925.

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[1] This case, *Helvering v. Warren Tool Corp.*, No. 42, has been placed by the Court on the Summary Docket with *Helvering v. Ohio Leather*, No. 40, and *Helvering v. Strong Mfg. Co.*, No. 41, which are, in so far as the major legal questions, substantially similar cases. The petitioner has filed one brief for all three cases. References in this, the brief of the respondent in No. 42, to the record (R. ...) are to the record (top paging) in No. 42, the Warren Tool Corporation case. References to other records are thus—(Ohio, R. ....) for No. 40 and (Strong, R. ....) for No. 41.

III. STATEMENT OF THE CASE.

A. Nature of Proceedings.

The respondent, Warren Tool Corporation (hereinafter sometimes referred to as "the taxpayer"), appealed to the United States Board of Tax Appeals from a determination by the petitioner, the Commissioner of Internal Revenue (hereinafter sometimes referred to as "the Commissioner") that the taxpayer owed additional income taxes for the years 1936 and 1937 in the amounts of $3,037.25 and $3,193.53, respectively. The cases were consolidated for hearing. Items relating to depreciation and development expenses for the year 1936 and items relating to reserve for quantity discounts, capital stock tax and other taxes for the year 1937 were removed from consideration in the cause by the taxpayer's abandonment. (Opinion Board of Tax Appeals, Record 23.) The Commissioner contended that there still remained deficiencies of income tax (i.e. surtax on undistributed profits) in the amounts of $1,587.37 for the year 1936 and $2,076.30 for the year 1937. The Board of Tax Appeals, in an opinion not officially reported but set forth in the Record, pages 17 to 23, held that the Commissioner erred in determining said additional deficiencies. The Circuit Court of Appeals affirmed the Board of Tax Appeals.

B. Question Presented.

The tax involved is the one imposed by Section 14(b) of the Revenue Act of 1936 and is measured by the corporation's "undistributed net income" which is defined in Section 14(a)(2) as "the adjusted net income minus the sum of the dividends paid credit provided in Section 27 and the credit provided in Section 26(c), relating to contracts restricting dividends."

The controversy is over the allowance of credits under Section 26(c)(2) (set out in full under Statutes Involved, *infra*) for sinking fund payments required under a trust

indenture which compelled the taxpayer to pay to the Trustee on the first day of each April a sum of money equal to 25% of its net earnings for the calendar year next preceding. The Commissioner contends that the taxpayer is not entitled to the credits because the twenty-five per cent of the net earnings were not payable until the year following the taxable year and that the taxpayer can not claim a credit for irrevocably setting aside these funds because it was not expressly and explicitly required to do so by any particular language in the indenture. The taxpayer contends that it is entitled to the credits because it was required by the terms of the indenture to irrevocably set aside within the taxable year these amounts, and because upon consideration of its estimated net earnings toward the end of each taxable year it did so irrevocably set aside—by actually paying the amounts claimed as deductions. The taxpayer claims that the requirement to irrevocably set aside funds need not be express.

C. Statutes and Regulations Involved.

The Revenue Act of 1936; 74th Congress, Sess. II, Ch. 690; 49 Stat. 1648.

"Sec. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) Definitions.—As used in this title—

(1) The term 'adjusted net income' means the net income minus the sum of—

(A) The normal tax imposed by section 13.

(B) The credit provided in section 26(a), relating to interest on certain obligations of the United States and Government corporations.

(C) In the case of a holding company affiliate (as defined in section 2 of the Banking Act of 1933), the amount allowed as a credit under section 26(d).

(D) In the case of a national mortgage association created under Title III of the National Housing Act, the amount allowed as a credit under section 26(e).

(2) The term 'undistributed net income' means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26(c), relating to contracts restricting dividends.

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c):

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.

12 per centum of the portion of the undistributed net income which is in excess of 10 per centum and not in excess of 20 per centum of the adjusted net income.

17 per centum of the portion of the undistributed net income which is in excess of 20 per centum and not in excess of 40 per centum of the adjusted net income.

22 per centum of the portion of the undistributed net income which is in excess of 40 per centum and not in excess of 60 per centum of the adjusted net income.

27 per centum of the portion of the undistributed net income which is in excess of 60 per centum of the adjusted net income."

"Sec. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * *

(c) *Contracts Restricting Payment of Dividends—*

(1) *Prohibition on Payment of Dividends.*—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to

one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

(2) *Disposition of Profits of Taxable Year.*—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word 'debt' does not include a debt incurred after April 30, 1936."

"SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the dividends paid credit provided in section 27) provided for in this title shall be taken for the taxable year in which 'paid or accrued' or 'paid or incurred,' dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *"

* * * * *

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 26-2. *Credit in connection with contracts restricting payment of dividends.*—(a) The credit provided in section 26 (c) with respect to contracts restricting the payment of dividends is not available under every contract which might operate to restrict the payment of dividends, but only with respect to those provisions of written contracts executed by the corporation prior to May 1, 1936, which satisfy the con-

ditions prescribed in the Act. The charter of a corporation does not constitute a written contract executed by the corporation within the meaning of section 26 (c). The provisions recognized by the Act are of two general types, as follows:

(1) Those which come within section 26 (c) (1), in that they prohibit or limit the payment of dividends during the taxable year; and

(2) Those which come within section 26 (c) (2), in that they require the payment, or irrevocable setting aside, within the taxable year, of a specified portion of the earnings or profits of the taxable year for the discharge of a debt incurred on or before April 30, 1936.

* * * * *

(c) *Disposition of profits of taxable year.*—Under the provisions of section 26 (c) (2), a corporation is allowed a credit in an amount equal to that portion of the earnings and profits of the taxable year which, by the terms of a written contract executed by the corporation prior to May 1, 1936, and expressly dealing with the disposition of the earnings and profits of the taxable year, it is required within the taxable year to pay in, or irrevocably to set aside for, the discharge of a debt incurred on or before April 30, 1936. The credit is limited to that amount which is actually so paid or irrevocably set aside during the taxable year pursuant to the requirements of such a contract.

Only a contractual provision which expressly deals with the disposition of the earnings and profits of the taxable year shall be recognized as a basis for the credit provided in section 26 (c) (2). A corporation having outstanding bonds is not entitled to a credit under a provision merely requiring it, for example, (1) to retire annually a certain percentage or amount of such bonds, (2) to maintain a sinking fund sufficient to retire all or a certain percentage of such bonds by maturity, (3) to pay into a sinking fund for the retirement of such bonds a specified amount per thousand feet of timber cut or per ton of coal mined, or (4) to pay into a sinking fund for the retirement of such bonds an amount equal to a certain percentage

of gross sales or gross income. Such provisions do not expressly deal with the disposition of earnings and profits of the taxable year. A contractual provision, however, shall not be considered as not expressly dealing with the disposition of earnings and profits of the taxable year merely because it deals with such earnings and profits in terms of "net income," "net earnings," or "net profits."

D. Statement of Facts.

The taxpayer on November 1, 1932 executed a first mortgage and deed of trust to The Cleveland Trust Company (hereinafter called "the Trustee") securing bonds issued on that date in the amount of $50,000. Between November 1, 1932 and January 1, 1935 $18,000 more bonds were issued, and on January 1, 1935 $68,000 of the bonds were outstanding. The bonds bore interest at six per cent per annum. (Item 1 of Stipulation Correcting Errors in Printed Transcript[1] and R. 17 and 18.[2])

The sinking fund provision in the mortgage provided in part:

"ARTICLE IV.

Sinking Fund.

Section 1. For the purpose of creating the sinking fund for the redemption of the bonds issued hereunder, the Company hereby agrees to pay to the Trustee on or before the 1st day of April, 1935, and on or before the first day of April of each year thereafter to and including April 1, 1942, a sum of money equal to Twenty-five Per Cent (25%) of its net earnings for the calendar year next preceding. * * * The Company may, in lieu of depositing cash in whole or in part, purchase bonds

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[1] This typewritten stipulation executed by both parties by their respective attorneys was filed in this Court on July 27, 1942.

[2] All references "R" hereinafter in the Statement of Facts are to the Memorandum Findings of Fact and Opinion of the Board of Tax Appeals as found in the Printed Transcript filed in this Court, except where otherwise specifically indicated.

issued hereunder at a price not exceeding the redemption price thereof as fixed by the provisions of Article V hereof, and deliver such bonds to the Trustee for credit against said sinking fund obligations to the extent of the purchase price (excluding the accrued interest) paid therefor by the Company. * * * Prior to the first day of April in each year above mentioned, the Company shall also file with such Trustee a statement sworn to by one of such officers showing the amount of the Company's net earnings for the preceding calendar year computed in the manner hereinbefore provided and duly certified by such accountant or accountants." (R. 18, and Item 2 of Stipulation Correcting Errors in Printed Transcript.)

For 1934 the petitioner had no net earnings and so advised the Trustee by letter dated March 30, 1935. (R. 18.)

The taxpayer's certified net earnings for the year 1935, computed in the manner required by the sinking fund provision of the indenture amounted to $15,020.84 and it owed the Trustee $3,755.21 for the sinking fund. (R. 18.)

Considering the sinking fund requirement, the taxpayer purchased on or about March 23, 1936, out of its net earnings for 1935, from the holders thereof, $5,500 of its first mortgage bonds and on that date delivered them to the Trustee. The Trustee cancelled, discharged and cremated the bonds and applied them against the sinking fund requirements, which amounted to $3,755.21, as shown above. (R. 18.)

On or about December 3, 1936 the taxpayer's accountant estimated that the taxpayer's net earnings, under the above quoted section of the mortgage, for the calendar year 1936, would be about $50,000. It delivered to the Trustee $12,500 of its first mortgage bonds, for which it had paid $12,755. These bonds had been purchased from their holders between November 9, 1936 and December 3, 1936. These bonds were delivered in consideration of the sinking fund requirement and were cancelled and cremated by the Trustee. (R. 18-19.)

On February 10, 1937 the taxpayer certified to the Trustee that its net earnings for the calendar year ending December 31, 1936, were $44,068.90 and therefore the payment owed to the Trustee was $11,017.22, which had been satisfied on December 3, 1936 as above related. (R. 19.)

On or about December 2, 1937, the taxpayer's accountant estimated that its net earnings under the mortgage for the calendar year 1937 would be about $50,000. It delivered to the Trustee $10,000 of its first mortgage bonds, for which it had paid $10,000. On or about December 1, 1937, these bonds had been redelivered to the taxpayer by The Second National Bank of Warren which had held the bonds as collateral security for a loan to the taxpayer, upon the taxpayer paying the bank a $10,000 note which was due December 1, 1937. These bonds were cancelled and cremated by the Trustee. (R. 21.)

On or about December 28, 1937, the taxpayer, upon reconsideration of the matter, estimated that its net earnings for the calendar year 1937 would be about $52,000, based on the accountant's revised report. It delivered to the Trustee $4,000 more of its first mortgage bonds on December 28, 1937, for which it had paid $4,000. These bonds had been redelivered to the taxpayer by The Second National Bank of Warren on or about December 28, 1937, upon the taxpayer paying that bank $4,000 on a $10,000 note which was not due until December 1, 1938. These bonds were cancelled and cremated by the Trustee. (R. 22.)

The net earnings of the taxpayer for the year 1937 were thereafter determined by its accountant to be $52,214.10, and therefore of the $14,000 of its first mortgage bonds deposited in December, 1937, $13,053.52 were one-fourth of the net earnings. (R. 22.)

In December 1938, the taxpayer pursued the same method of operation as described above for the years 1936 and 1937. (R. 22.)

During the taxable years in question the taxpayer made its income tax returns upon an accrual basis. (R. 22.)

IV. THE ARGUMENT.

Summary of the Argument.

Both the Sixth Circuit Court of Appeals and the Board of Tax Appeals sustained the taxpayer's position that in the determination of its adjusted net income, as defined in Section 14(a)(2) of the Revenue Act of 1936 for the computation of its undistributed profits tax the sums taken from its current earnings and profits (up to twenty-five per cent of its net income as determined in accordance with the provisions of the sinking fund agreement) used to purchase bonds which it then deposited for discharge and cancellation with the trustee during the taxable year for the purpose of meeting the sinking fund requirements of that year, were sums constituting allowable credits under Section 26(c)(2) of the Act. The Board in its memorandum opinion followed its decision in *Strong Manufacturing Company*, 41 B. T. A. 1273. Likewise the Circuit Court of Appeals in its memorandum opinion, 124 F. (2d) 397 (R. 31), in accordance with its opinion in *Commissioner v. Strong Manufacturing Co.*, 124 F. (2d) 360. A similar result was reached by the Board in *The Ohio Leather Company*, which was likewise affirmed by the Sixth Circuit Court of Appeals, 124 F. (2d) 397 in accordance with its opinion in *Commissioner v. Strong Manufacturing Co.*

The respondent contends that under the facts as set forth above, the Board of Tax Appeals and the Circuit Court of Appeals properly allowed the claimed credits for the following reasons:

1. It was the basic intention of Congress to force all available current earnings of corporations to go through the tax mill in the hands of shareholders. To accomplish this after it levied a normal tax it taxed "undistributed income" at rates which were progressively higher as the percentage of undistributed income, compared with total income increased. In determining undistributed profits

there were of course deducted the earnings actually distributed in the form of dividends. Also recognizing that some corporations were under obligations which prevented them from making these distributions it gave credit for sums withheld under "Contracts Restricting Payment of Dividends" and classified these into classes—those which were (1) "Prohibition on Payment of Dividends" and (2) those requiring a "Disposition of profits of taxable year." (Thus Congress entitled Section 26(c) and its two subsections—(1) and (2).

Toward the close of each taxable year the taxpayer made payments to a sinking fund in obedience to a provision of a trust indenture which required that the taxpayer pay to the trustee on April 1 of each year an amount equal to 25% of its net earnings for the preceding year. The amounts paid in December of each year were 25% of the estimated earnings and the amounts claimed are 25% of the actual earnings. Taxpayer does not base its claim upon the fact that it "paid." Taxpayer paid at the time it did because that was the best evidence of its having actually "irrevocably set aside" these sums. Taxpayer might have paid over to a trustee or even set up a special account in a bank or taken any other step but it was essential that taxpayer take a definitive step which would constitute an irrevocable setting aside because the credit is limited "to the extent that such amount has been so paid or set aside."

It is the taxpayer's contention that under the trust indenture it was required to irrevocably set aside within the tax year these sums from its earnings for that year within the meaning of Section 26(c)(2) of the Revenue Act as that section stands alone or, as read in the light of Congressional intent and aim.

The taxpayer also contends that the Commissioner's interpretation of the section ignores certain of its words and phrases and inserts matter which is not there and accordingly such interpretation is erroneous.

A. The sinking fund agreement was a contract to "irrevocably set aside within the taxable year for the discharge of a debt" the sums—up to twenty-five per cent of the net earnings—actually set aside.

There are a number of requirements which must be met before a taxpayer may be granted a credit for having irrevocably set aside sums, thus it must have been pursuant to a contract:

(a) in writing;

(b) executed by the taxpayer before May 1, 1936;

(c) expressly dealing with the disposition of earnings and profits of the taxable year; and

(d) requiring the paying or irrevocably setting aside for the payment of a debt within the taxable year of the sums claimed as a credit.

The Commissioner concedes the existence of the first three requisites and only challenges the existence of the fourth.

The taxpayer contends that the sinking fund agreement to *pay* on April 1, a sum of money equal to twenty-five per cent of its net earnings constituted an agreement to "irrevocably set aside" such earnings as they were earned, i.e., "within the taxable year." The actual payment was the practical way of evidencing this setting aside. A transfer to another trustee, other than trustee under the indenture, would have been equally effective. The sinking fund covenant imposed a fiduciary duty upon the taxpayer. The Commissioner makes the argument that the taxpayer was free to use until April 1 for its own purposes these funds for the purchase of new equipment, investment or other "appropriate" purposes, except, the Commissioner does concede, that the taxpayer was under an obligation "imposed by operation of law, to refrain from such a dissipation or distribution of the specified percentage of net earnings which would put the percentage beyond the reach of the trustees or creditors." (Pet. Br. p. 18.) This attempt

to introduce a class of permitted and non-permitted uses indicates, we believe, as well as anything we could say, the weakness of the Commissioner's position. For either there was merely a debt or there was a complete fiduciary obligation. This is practically like saying that a trustee may use for his own purposes trust funds as long as he is careful to put the money into assets upon which the beneficiaries may levy after they get a judgment against the trustee. Here under the trust indenture the taxpayer was obligated to pay an amount[1] equal to 25% of its net earnings in cash (or in bonds) to the trustee and the taxpayer could not use the money for its own purposes merely on the excuse that it was still keeping it available for the trustee and the creditors.

In *Morse v. Bay State Gas Co. of Delaware*, 91 Fed. 938, an equity suit on income bonds (and the bonds in the case now before this Court have a dual obligation on the taxpayer, one to pay at a day certain, the other to set aside for payment a percentage of net earnings) Circuit Judge Dallas, in overruling a demurrer which had raised the question of the right of the holders to bring an action in equity and holding that a court of equity had cognizance of the action, said:

> "• • • But, again, it is contended that no duty was assumed with which a court of equity is competent to deal; that what is set up amounts to but a breach of contract. I cannot assent to this. Those who took these bonds did not, as has been pointed out, accept mere promises to pay. They, of course, relied, and had a right to rely, upon the fidelity of the corporation for the production, protection and application of net earnings, and by its necessarily implied undertaking to

[1] Any doubt that this must be considered a trust for the purpose of this statute would be dispelled by the provision of Section 26(c)(2) that: "• • • For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits."

exercise good faith in this regard the corporation assumed an obligation which was fiduciary in its nature, and which, therefore, is of equitable cognizance. * * *" 91 Fed. 938 at 939.

Corresponding to the fiduciary duty thus imposed on the taxpayer, there was an equitable interest in the income vested in the trustee for the benefit of the bondholders. The right to have a portion of income devoted to the sinking fund was a separate right in addition to and independent of the right to have the bonds paid at maturity in 1942. (*New York Trust Co. v. Michigan Traction Co.*, 193 F. 175 (Dist. Ct. Mich. 1912).) And therefore there was created an equitable lien. In *Barnes v. Alexander*, 232 U. S. 117 (1914), Barnes, an attorney employed on a contingent fee of one-fourth, promised Alexander and Street one-third of this one-fourth if they, Alexander and Street, would attend to the case. The court held that this promise created a lien upon the fund the instant it was received by Barnes because even though originally words of contract rather than conveyance had been used:

"the important thing is not whether they used the present or the future tense but the scope of the contract. In this case it aimed only at the fund. * * * the moment the fund was received the contract attached to it as if made at that moment. It is an ancient principle even of the common law that words of covenant may be construed as a grant when they concern a present right [citing cases]. And it is one of the familiar rules of equity that a contract to convey a specified object even before it is acquired will make the contractor a trustee as soon as he gets a title to the thing. [Citing cases.]" 232 U. S. 117 at 121.

In another contingent fee case, *Geddes v. Reeves Coal & Dock Co.*, 20 Fed. (2d) 48 (C. C. A. 8 (1927)) the court said:

"The general principles, rules and practice in equity applicable to this case have been stated by Pomeroy

and his statement of them has been adopted and confirmed by repeated decisions of the Supreme Court and of other courts. He wrote: 'Every express executory agreement in writing, whereby the contracting party sufficiently indicates an intention to make some particular property, real or personal, or fund, therein described or identified, a security for a debt or other obligation, or whereby the party promises to convey or assign or transfer the property as security, creates an equitable lien upon the property so indicated, which is enforcible against the property in the hands not only of the original contractor, but of his heirs, administrators, executors, voluntary assignees and purchasers or encumbrancers with notice.' 3 *Pomeroy's Equity Jurisprudence*, § 1235.

"'It is well settled that an agreement to charge, or to assign, or to give security upon, or to affect property not yet in existence * * * or property to be acquired by him in the future * * * does constitute an equitable lien upon the property so existing or acquired at a subsequent time, which is enforced in the same manner and against the same parties as a lien upon specific things existing and owned by the contracting party at the date of the contract.' 3 *Pomeroy's Equity Jurisprudence*, § 1236." 20 F. (2) 48 at 50.

In *Klaustermeyer v. The Cleveland Trust Co., Assignee*, 89 Ohio St. 142, 105 N. E. 278 (1913), Klaustermeyer was a director of The Euclid Avenue Trust Company, which was in financial difficulty. He and others agreed each to loan the bank $5,000.00 upon the condition that they each should be given security for the deposit from the collateral securities owned by and in the possession of the bank. Klaustermeyer did make the loan but did not receive any securities as collateral. Nor did the bank at any time segregate any securities for him. Three days after the loan the bank made an assignment for the benefit of its creditors. In holding that Klaustermeyer had an equitable lien on the assets of the bank (no rights of third parties having intervened) the Ohio Supreme Court said:

"Now, one of the fundamental maxims of equity is, '*equity regards as done that which ought to be done.*'

" 'The broad meaning of this maxim is that where an obligation rests upon a person to perform an act equity will treat the person in whose favor the act should be performed as clothed with the same interest and entitled to the same rights as if the act were actually performed. It is closely connected with and probably derived from the principle of regarding intent and substance rather than form. * * * The principle also lends its force to the establishment of liens and charges which could not be sustained at law, and to working out justice by fixing *rights as of the time when the obligation first accrued,* rather than according to circumstances subsequently arising.' 16 *Cyc.* 135." (Italics the court's.) 89 Ohio St. 142 at 147, 105 N. E. at 280.

That the trustee in the present case could restrain the dissipation of the earnings of the corporation is indicated by the decision in *Marine Midland Trust Co. v. Alleghany Corporation,* 28 F. Supp. 680 (Dist. Ct. N. Y. 1939). In that case a preliminary injunction was granted the trustee prohibiting the defendant obligor from disposing of certain assets on the ground that the "reasonable interpretation" of the trust indenture together with the preliminary letter and offering circular was that the defendant had promised to maintain as collateral security a deposit of securities in an amount of not less than 150% of the bonds outstanding.

From the foregoing it is clear, we believe, that the taxpayer was under a duty to "irrevocably set aside" the sums that it did use for the purchase of the bonds within the taxable years and therefore to the extent that these sums constituted twenty-five per cent of its net earnings it is entitled to a credit under 26(c)(2) of the Revenue Act of 1936 in determining its undistributed net income as defined in Section 14(a)(2).

B. Where a corporation is required to devote a portion of its net earnings for a taxable year to satisfy a sinking fund obligation entered into prior to May 1, 1936, it is clear under the statute and Congress manifestly intended that the amounts thus irrevocably set aside must, to the extent they were required to be set aside, be deducted from its adjusted net income in order to determine its undistributed income subject to surtax. Therefore the credit is properly claimed in this case because the statute standing alone, when every part of it is considered, allows the credit.

The taxpayer contends that even construing both the statute and the indenture in the most confined way it is entitled to the credits, but if there be any doubt as to this, it is entitled to a liberal construction of the statute and under such construction the allowance of the credit is manifestly proper.

Obviously even under a strict construction of Section 26(c)(2) of the Revenue Act of 1936 all parts of the section must be considered. In *Ex parte Public Bank*, 278 U. S. 101 (1928) the Supreme Court said at page 104:

> "• • • In other words, we are asked to ignore the quoted words and read the section as though they were not there.
>
> But we are not at liberty thus to deny effect to a part of a statute. No rule of statutory construction has been more definitely stated or more often repeated than the cardinal rule that 'significance and effect shall, if possible, be accorded to every word. As early as in *Bacon's Abridgement*, sect. 2, it was said that "a statute ought, upon the whole, to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant."' *Market Co. v. Hoffman*, 101 U. S. 112, 115. • • •"

The Commissioner has totally disregarded this fundamental principle when, in his brief in this Court, he has insisted that the credit for sinking funds should be denied because the sums were not "payable" until the early part of the year following the taxable year in which the earn-

ings and profits[1] accrued and therefore the setting aside was not required within the taxable year. The statute reads in full as follows:

> "(2) *Disposition of Profits of Taxable Year*—An amount equal to the *portion* of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be *irrevocably set aside within the taxable year for the discharge of a debt*; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a *percentage* of earnings and profits shall be considered a requirement to pay or set aside such *percentage* of earnings and profits. As used in this paragraph, the word 'debt' does not include a debt incurred after April 30, 1936" (Italics ours.)

The Commissioner wholly disregards the italicized parts.

The taxpayer contends that the use of the phrase "irrevocably set aside for the discharge of a debt" contemplates situations where, as here, the actual date of payment is postponed to a later date or event and the use of the phrase "portion of the earnings and profits of the taxable year" together with the express reference to requirements for setting aside a "percentage" contemplate situations where, as here, the amounts allowable as deductions are parts from (i.e. "portions of" or "percentages of") an *entire year's* net earnings.

The fact that Congress provided for cases where the "payment" of the debt was to be postponed until after the

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[1] The indenture uses the phrase "net earnings." (R. 18.) This by the Treasury Department's Regulations 94 Relating to the Income Tax under the Revenue Act of 1936 § 26(2)(c) is the equivalent of "earnings and profits." The Commissioner does not contend otherwise.

taxable year is clearly shown by a consideration of the differences of language in the two grounds for credits under Section 26(c)(2), *viz.*: "The portion of the earnings and which is required * * * [1] to be paid within the taxable year *in* discharge of a debt, or [2] to be irrevocably set aside within the taxable year *for* the discharge of a debt * * *." (Italics ours.) The word "for" under [2] is used in the sense of "for the future," as contrasted with the word "in" under [1] used in the sense of "in the present." Clearly the phrase "within the taxable year" as used in the second ground modifies "set aside" rather than "for the discharge of a debt." Otherwise there would be no purpose in having [2] at all. In other words, the requirement is that the setting aside take place in the taxable year and it is sufficient if it is an irrevocable setting aside to take care of the discharge of a debt at some later date.

The legislative meaning as expressed in its plain words (*Helvering v. Northwest Steel Mills*, 311 U. S. 46, 49 (1940)) was to grant a credit for a setting aside measured by an *entire year's* earnings and profits. First Congress designates a "*portion* of the earnings and profits of the taxable year * * *" then it provides "For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a *percentage of earnings and profits* shall be considered a requirement to pay or set aside such *percentage* of earnings and profits."

In *Helvering v. Northwest Steel Mills*, 311 U. S. 46, this Court held that a corporation's charter taken with a law of the state of incorporation prohibiting dividend payments, except from surplus, did not constitute a "contract" within the meaning of Section 26(c)(1) of the Revenue Act of 1936, which grants a credit for sums which the taxpayer could not distribute as dividends "without violating a provision of a written contract." The taxpayer made the further argument that the tax, as applied

to it, was unconstitutional as a confiscation of property without Due Process because the tax was imposed only on undistributed income, and it claimed it could have no undistributed net income as long as it had an existing deficit.

In reply, this Court said:

> "• • • But the surtax here is imposed upon the undistributed net income of the corporation 'for each taxable year.' [Obviously, this Court was here quoting from Section 14(b) *Imposition of Tax* set out in full in *I. Statutes and Regulations Involved, supra.*] It is true that the surtax is imposed upon the annual income only if it is not distributed, but this does not serve to make it anything other than a true tax on income within the meaning of the Sixteenth Amendment. Nor is it true, as respondent urges, that because there might be an impairment of the capital stock, the tax on the current annual profit would be the equivalent of a tax upon capital. Whether there was an impairment of the capital stock or not, the tax here under consideration was imposed on profits earned during a definite period —a tax year—and therefore on profits constituting income within the meaning of the Sixteenth Amendment." 311 U. S. 46 at 53.

The words "portion" and "percentage" by definition and by common usage mean a part of a whole. Congress taxed the entire (i.e. twelve months) undistributed net earnings. It is not only common knowledge but also specifically proved in the *Strong Manufacturing Company* case (No. 41) that the ascertainment of net earnings of manufacturing is impossible of ascertainment until after close of the taxable year. Thus Article 22 (c)-1 of the Treasury Department Regulations 94 (relating to the Revenue Act of 1936) in defining gross income provides in part:

> "Art. 22(c)-1. *Need of inventories.* In order to reflect the net income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor."

Furthermore, the taxpayer was on an accrual basis (R. 22) and Section 43 of the Revenue Act of 1936 provides:

> "Sec. 43. Period for Which Deductions and Credits Taken.
>
> The deductions and credits (other than the dividends paid credit provided in section 27) provided for in this title shall be taken for the taxable year in which 'paid or accrued' or 'paid or incurred,' dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *"

The specific elimination of Dividends Paid,—one of the two grounds for credit enumerated in Section 14(a)(2) defining "undistributed net income"—clearly indicates the inclusion of the other section—Contracts Restricting Dividends—as one where the accrual is to be permitted. The differentiation between allowing an accrual of amounts used or set aside within the taxable year to pay debts and the disallowance of an accrual for dividends is consistent with the general purpose of the 1936 Act—to raise revenue immediately by forcing corporations to disgorge earnings —since with the relatively slight possibility of capital gains the payment of a debt does not create taxable income for the holder of the obligation, while the payment of a dividend does in most instances result in increased taxes to stockholders.

The case of deductions for bad debts under Section 23(k) of the Revenue Act of 1936 is somewhat analogous to the present case. Under that section "debts ascertained to be worthless and charged off within the taxable year * * *" are deductible from gross income to determine net income. The requirement "within the taxable year" in so far as the physical act of charging off is required may be met in the first months of the succeeding as of the preceding taxable year. *Hamlen v. Welch*, 116 F. (2d) 413 (1940).

In *Kentucky Rock Asphalt Co. v. Helburn*, 20 F. Supp. 364 (Dist. Ct. Ky. 1937) aff'd. 108 F. (2d) 779 (C. C. A. 6, 1940), although the deduction was disallowed on other grounds, the court said at page 368 of 20 F. Supp.:

> "As I have heretofore stated, the administration of the income tax revenue statute is concerned with practical things, and it is hardly feasible for the officers of a corporation to immediately determine at the close of the year deductible bad debts. While the language used in the act provides that the ascertained bad debts shall be 'charged off within the taxable year,' it is not to be presumed that the Congress intended this language to mean all entries on the books of a corporation should be made and the books closed at midnight of the day the taxable year ended. As a practical matter, many facts are assembled as a basis for the book entries after the close of the year, and the Congress did not intend there should be an essential departure from the usual course of business in making book entries in order to comply with the income tax laws."

While thus attempting to eliminate or ignore portions of the statute, the Commissioner is also attempting to insert an additional requirement, i.e., that it is not sufficient that the legal effect of the indenture be to require the setting aside of the earnings, but that there must be expressly in so many words this requirement. Congress did not say this. The attempt of Commissioner to insert "expressly" before the phrase "to be irrevocably set aside within the taxable year" is obviously wrong. Congress was content to provide that only one provision of the contract be "express" and that was the provision which makes it obligatory to use earnings and profits i.e., "• • • which provision *expressly* deals with the disposition of earnings and profits of the taxable year • • •."

For his only specific case authority the petitioner cites *Helvering v. Moloney Electric Co.*, 120 F. (2d) 617 (C. C. A. 8, 1941) (cert. den. Nov. 10, 1941, 314 U. S. 682) (prelim. print) (Rehearing denied Jan. 12, 1942, 315 U. S. 826).

(prelim. print), and *Antietam Hotel Corporation v. Commissioner*, 123 F. (2d) 274 (C. C. A. 4, 1941). While in these cases both Circuit Courts denied claims for credits under Section 26(c)(2) for sinking fund payments, the facts were so different in each case that the opinions would seem to be of only limited value in consideration of the present cases before this Court.

In the *Moloney* case there were claims for two credits. The first was under a provision in a trust indenture that the taxpayer would on the first day of every June as long as there were any bonds outstanding pay "a sum equal to 2% of the largest amount of debenture bonds at any time outstanding, * * *." This requirement was absolute and did not in terms depend on the existence or non-existence of earnings and profits, and therefore was not a provision which, as required by the statute, "expressly deals with the disposition of earnings and profits of the taxable year." Therefore, the court denied this 2% credit.

The claim for a second credit in the *Moloney* case was based on the next phrase in the same sinking fund provision whereby the taxpayer also agreed to "pay on said date [June 1] to the said trustee 20% of the net earnings, for the next preceding year, as hereinafter defined, of the Company in excess of Three Hundred Twenty Thousand Dollars * * *." It was further provided that this 20% should be set aside not later than April 1. Both the Board and the court denied the credit. Reasons for these decisions included (a) the fact that there was no claim on the earnings except those in excess of $320,000; (b) the taxpayer was specifically given until April 1 of the following year to set aside its earnings, and (c) the statement in the opinion of the Board, quoted by the court:

> "* * * There is no evidence upon which to base a conclusion that any portion of the amount paid in 1936 was paid because of petitioner's obligation to apply 20 percent of its net earnings in excess of $320,000 toward the reduction of its indebtedness. The record does not

disclose whether the payment was made near the close of the year when it was apparent that the earnings would be in excess of $320,000 or whether it was made earlier in the year when the earnings were much less than that amount. It seems to be obvious that the payment was made under the option contained in section 3 of article III rather than because of any requirement of the contract that it be made. In any event, in the absence of any showing as to when the payment was made and in the absence of any showing as to the amount of net earnings at that time, it is impossible to find that the payment was made because of the requirement that 20 percent of the net earnings in excess of $320,000 be applied on the debt." 42 B. T. A. at p. 86, as quoted in 120 F. (2d) 617 at 621.

The *Antietam* case (*supra*) does by way of dictum indicate that if it were necessary for decision it would have held that credit could not be granted unless the contract requiring the setting aside of a portion of a year's earnings *expressly* and in its terms required that the setting aside be done within the taxable year. That is the construction sought by the Commissioner here, but, as we believe we have shown, an untenable one. The actual decision in the *Antietam* case was that whether or not required during the taxable year, there had in fact been no payment or setting aside and of course the statute limits the credit "to the extent, that such amount has been so paid or set aside." In other words the only tangible recognition made by the Antietam Hotel corporation was the sinking fund payment in the year following the tax year.

"* * * It is clear from the record, however, that these funds were never actually segregated from the taxpayer's other moneys during the taxable years in question. Indeed, the evidence discloses that during the taxable years in question, the funds actually remained in petitioner's general bank account, and it is quite clear that actual payments to the Trustee were not made during the taxable years, but were, in each instance, paid by check during March of the year

after the taxable year. Thus, there was no definitive act within the taxable year, which divested the corporation's control over the funds." 123 F. (2) at 276-7.

We think that the Circuit Court of Appeals for the Sixth Circuit was right in its treatment of these two cases when it said in its decision in *Commissioner v. Strong Mfg. Co.*:

> "We are mindful of the fact that since the argument in the instant case, in *Antietam Hotel Corp. v. Commissioner of Internal Revenue*, 4 Cir., 123 F. 2d 274, it was held 'that as an indispensable condition precedent to the allowance of the credit, the contract itself must in terms require that a portion of the earnings and profits of the taxable year be * * * irrevocably set aside within the taxable year.' We do not arrive at the same conclusion, for we do not find from the language of the statute that the contract must require the earnings to be irrevocably set aside, in terms. With regard to the case of *Helvering v. Moloney Electric Co.*, 8 Cir., 120 F. 2d 617, in which it was held that the taxpayer was not entitled to credit under the section of the statute in question, it appears that there was no showing in that case what the earnings of the corporation were, when the payment on the indebtedness was made, or whether the payment was ever made because of any contract requirement; and these circumstances were of paramount significance in that adjudication. Confronted by entirely different facts, it would appear that further discussion, for the purpose of distinguishing the cited case, would be fruitless." 124 F. 2d 360, 365-6.

C. The Congressional intent and the legislative history of the undistributed profits tax imposed by the Revenue Act of 1936 supports the taxpayer's interpretation.

This is a case involving a surtax imposed by Congress on undistributed profits (after they had already been subject to a normal tax) for the avowed purpose of forcing corporate profits into the hands of shareholders where they would be subject to tax. Thus, in the Report on the Revenue Bill of 1936 of the House of Representatives Committee on Ways and Means, after quoting in full the message of the President, the Committee said:

> "The President requests the Congress to raise $620,000,000 of additional revenue annually by some form of permanent taxation. He suggests some form of undistributed-profits tax. Your committee recognizes the fact that the greatest defect in our present system of taxation lies in the fact that surtaxes on individuals are avoided by impounding income in corporate surpluses. Therefore, your committee proposes a plan of taxation which taxes a corporation on the net income, but which fixes the rate in accordance with the proportion of the net income, undistributed.
>
> "The major purposes of the change in the method of taxing corporate incomes are (1) to prevent avoidance of surtax by individuals through the accumulation of income by corporations, (2) to remove serious inequities and inequalities between corporate, partnership, and individual forms of business organization, and (3) to remove the inequity as between large and small shareholders resulting from the present flat corporate rates.
>
> "It is well recognized that the corporate form of doing business enjoys certain advantages over individual and partnership businesses. The existing law creates purely artificial additional advantages in some cases and artificial disadvantages in others, depending upon the size of the enterprise and the character of its ownership. Individuals and partnerships can not minimize their taxes by failure to distribute their business earnings. Corporations should not be permitted to withhold from the beneficial shareholders unneeded

> corporate income at the expense of the revenues of the United States and to the detriment of the shareholder. The bill proposes to remove many of these inequities by relieving from tax corporations which distribute all their net earnings annually as earned, and by taxing corporations accumulating their net income at a rate to compensate to a large extent for the amount of tax on the shareholders' income lost by reason of the failure to make a complete distribution. Adequate safeguards are provided in the bill to prevent unreasonable taxation of incomes in the case of corporations in distress or with inadequate earnings to take care of their immediate business needs. * * *" H. of Rep. Report No. 2475, 74th Congress, Sec. Sess. Cum. Bul. 1939-1 (part 2) 667, 669.

Fairness demanded and Congress provided that credit be given for both dividends paid (Section 27 of the Revenue Act of 1936) since that was the purpose of the surtax and also for "Contracts Restricting Payments of Dividends" as the Congress entitled Section 26(c) of the Revenue Act.

The Commissioner in his brief (pages 19 to 29) states that there were two proposed forms[1] of the tax on undistributed profits—one the House bill and the other the Senate bill—before the adoption of the bill in its final form. He shows that under each of the proposed forms and the "cushions" in each there would have been little or no relief for a taxpayer under the circumstances present in this case and therefore, so the argument goes, the Court should not find in the existing "cushions" any relief for the taxpayers. This conclusion is false, it can be shown, both generally and specifically. *Generally* in that if the Congress as a whole is unable to agree on forms noteworthy for their harshness, then it would be supposed that the sub-

[1] As a matter of fact there were at least four major forms of the bill, which embodied two distinct theories of the tax, before the fifth and final conference form was adopted. For the purpose of presenting a full picture there is included in the appendix a detailed explanation of the changes, as shown by the Commerce Clearing House Special Reports on the Revenue Bill of 1936.

stituted bill had relief provisions of a more adequate nature. This was done, for as Senator Connally said to the Senate in explaining the sections which finally became the law:

> "• • • One of the reasons that made some of us timid about embracing the new principle was that the Government and the Treasury had no experience, had the benefit of no accumulated studies as to a tax on undistributed profits. So instead of discarding all present taxes and embarking upon an absolutely untried and new plan, we proposed that we should retain in large measure the present normal rates and cautiously extend our footsteps into the new and untried territory. That is what we have done." (Cong. Rec., Vol. 80, p. 10,474.)

Specifically the facts that show the falsity of the Commissioner's argument appear upon careful examination of each of the proposed bills and comparison of them with the enacted bill. In the House bill there was, as stated by the Commissioner, a proposal to entirely eliminate the "normal" tax and substitute a tax of from zero to 42½ per cent on the undistributed net income (Appendix A, p. 38). There was partial relief given by specific provisions regarding deficit corporations or corporations heavily in debt (See Sections 14 and 16 of Appendix A). And it may be admitted, as stated by the Commissioner, that the taxpayer in this case would have had only partial relief from these specific cushions. What Commissioner overlooks is the fact that total effect was to be greatly diminished by the omission of the normal tax. Congressman Vinson stated that under the House bill there would be a "cushion" in that small corporations (i.e., ones with income up to $10,000) would retain up to 42% of their net income and the larger corporations up to 31.9% without paying any more tax than under the then existing law and rates of the 1934 Act (Cong. Record, Vol. 80, pp. 6212-13).

The "cushion" in the Senate Committee bill (Appendix C, p. 51) was the moderateness of the straight rate

of 7% on undistributed profits in addition to the "normal tax" which the Senate restored. This moderate rate permitted the Senate in its proposed bill "to eliminate the complicated relief provisions of the House bill relating to debt and deficit of corporations." (Senator King, Cong. Record, Vol. 80, p. 8649.)

The "cushion" in the form of the low surtax rate was not enough to satisfy the Senate, which added by a floor amendment Section 26(c)(2) in the form in which it was finally adopted. See Appendix D, p. 56.

The final bill contained neither of the original "cushions"—that is it has the regular "normal" tax, Sec. 13[1] with rates from 8% to 15%[1] plus the "Surtax on Undistributed Profits" with rates from 7% to 27%. This situation made it more imperative than ever that the relief given by the Senate floor amendment to corporations which, by contract, inevitably had to draw upon current earnings to pay prior indebtedness, should be retained.

Likewise misleading and irrelevant is Commissioner's argument on the "dividend year" point (Pet. Br. 25-28). Congress first provided for a "dividend year" to enable a corporation to have some time after the close of the taxable year to cast up its accounts, determine how much

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[1] SEC. 13. NORMAL TAX ON CORPORATIONS.

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the normal-tax net income of every corporation, a normal tax as follows:

Upon normal-tax net incomes not in excess of $2,000, 8 per centum.

$160 upon normal-tax net incomes of $2,000; and upon normal-tax net incomes in excess of $2,000 and not in excess of $15,000, 11 per centum in addition of such excess.

$1,590 upon normal-tax net incomes of $15,000; and upon normal-tax net incomes in excess of $15,000 and not in excess of $40,000, 13 per centum in addition of such excess.

$4,840 upon normal-tax net incomes of $40,000; and upon normal-tax net incomes in excess of $40,000, 15 per centum in addition to such excess.

it wanted to distribute in the way of dividends. Later this was eliminated and in response to questions Mr. Hill, Chairman of the Subcommittee of the House Ways and Means Committee, said, as quoted on page 28 of Commissioner's Brief, that corporations for the purpose of distribution of dividends would know before the end of the year "approximately what their earnings are." Therefore, petitioner's argument goes, Congress was aware of the difficulties which would prevent a corporation from making an exact determination of its sinking fund payment within the taxable year and therefore did not intend, that the taxpayers whose debt payments were to be measured by the net income of an entire year.

This argument of the petitioner ignores three fundamental points:

1. The difference between the determination of the amount *desirable* to pay out as dividends and the amount *required* to be paid to a sinking fund. In the case of dividends a corporation's board of directors upon a close approximation of its net earnings fixes a lump sum that will usually give an "even" amount per share—as $1.50, $4.00—$5.25. That is, there is no need to distribute right down to the last dollar of earnings or of a fixed percentage of earnings. On the other hand the sinking fund requirements are for *exact* amounts—viz., for this taxpayer $11,017.22 in 1936 and $13,053.52 in 1937. That is why Congress provided credits for money which had to be "irrevocably set aside within the taxable year for the discharge of a debt."

2. A primary aim of the undistributed profits tax was that "unduly accumulated earnings and profits • • • go through the tax mill in the hands of the shareholder" (Congressman Buck at Cong. Record, Vol. 80, p. 6228). And also it was part of this aim that the shareholders would not be able to defer distributions until such times as it suited—for example, in a year in which they would have

losses to offset the income. On the other hand the payment of debts rarely creates taxable income in the hands of the creditor. Thus Congress permitted a credit for moneys which were merely irrevocably set aside for the payment of debts, while it required an actual payment of dividends for the dividend credit under Section 27.

3. Congress did put in Section 26(c)(2) after having heard the protests and with the intention of taking care of situations including obligations of the corporation to pay debts or withhold earnings for specific purposes under contract. (This, as the petitioner candidly points out in a footnote (Pet. Br. p. 23) but ignores in argument, was the explanation given by Senator Couzens at Cong. Record, Vol. 80, p. 9071 for the present form of 26(c)(2).)

In the course of his discussion of legislative proceedings the Commissioner also argues that the legislative history of the 1938 Act shows that the credit provisions of the 1936 Act were intended by Congress to be carefully limited. Granted that the legislative history of the 1938 Act shows an intent to make (which intent was carried out) the credit provisions of that Act broader than those of the 1936 Act, there is nothing in the legislative history of the 1938 Act, to show that the 1936 credit provisions were intended to be so limited as to deny the credit to this taxpayer. The Commissioner's argument might have some merit, if the taxpayer were relying upon the provisions of the 1938 Act as being declaratory of the Congressional intent in enacting the 1936 credit provisions, but the fact that Congress subsequently enlarged the credit provisions cannot serve as a basis for denying the credit to one who comes within the terms of the statute. Cf. *Penn Mutual Life Ins. Co. v. Lederer*, 252 U. S. 523, 537.

D. All of the rules of statutory construction applicable support the allowance of the credit in this case.

Other than the rule first cited in the preceding argument—that every word and phrase of a statute must be considered, *Ex Parte Public Bank*, 278 U. S. 101—we do not believe that rules of statutory construction are necessary or proper in the determination of this case, for as the Court said in *Western & Southern Life Ins. Co. v. Huwe*, 116 F. (2d) 1008, at 1010 (C. C. A. 6, 1941):

> "A taxing statute must be taken as it stands and where the language is plain and unambiguous as here, there is no ground for addition or subtraction."

If, however, there is doubt concerning the applicability of this statute then since the construction urged by the Commissioner makes part of the statute meaningless or absurd, the taxpayer is entitled to "that construction most favorable to him." *Partee v. Commissioner*, 114 F. (2d) 716, 719 (C. C. A. 6, 1940), Cf. *White v. Aronson*, 302 U. S. 16 at 21, for "taxation being an intensely practical matter, the courts, in construing laws in respect thereto should avoid, so far as possible, unjust and oppressive consequences." *Buhl v. Kavanagh*, 118 Fed. (2d) 315, 323 (C. C. A. 6, 1941), "While the title of an act will not limit the plain meaning of the text [citing cases] it may be of aid in resolving an ambiguity." *Maguire v. Commissioner*, 313 U. S. 1, 9 (1941); *United States v. Katz*, 271 U. S. 354, 357 (1926). The title of section 14 of the Revenue Act of 1936 imposing the tax here involved is "Surtax on Undistributed Profits" and the title of subsection 2 of section 26(c) "Contracts Restricting Payments of Dividends" is "(2) Disposition of Profits of Taxable Year," and as the Supreme Court said in the *Northwest Steel Mills* case, *supra*, "It is true that the surtax is imposed upon the annual net income *only if it is not distributed*, * * *" (italics ours) and "the intention of the Congress must be gathered from the language of the Act

because a tax statute must be construed to take from the taxpayer no more than it plainly intends." *United States v. Stroop*, 109 F. (2d) 891, 893 (C. C. A. 6, 1940).

In a case wherein the court held against the imposition of a federal estates tax, *Lynch, Collector, v. Union Trust Co.*, 164 Fed. 161 (C. C. A. 9th, 1908; cert. den. 214 U. S. 523), the court said (p. 163):

> "• • • Primarily in this connection it is necessary to keep in view a cardinal principle, to be applied generally to the interpretation of legislation whereby the government seeks to impose a duty or burden upon the property or rights of the citizen in the nature of taxation, and more especially applicable to *statutes such as this, seeking to impose a burden of a special or unusual character, and that is that, in all cases of doubt or ambiguity arising on the terms of such a statute, every intendment is to be indulged against the taxing power.*" (Italics added.)

The following Supreme Court cases have firmly established the rule that in determining the incidence of a tax doubts are resolved in favor of the taxpayer:

Hassett v. Welch, 303 U. S. 303, 314 (1938);
White v. Aronson, 302 U. S. 16, 20 (1937);
Gould v. Gould, 245 U. S. 151, 153 (1917).

The Commissioner makes the contention that the taxpayer is claiming an exemption and therefore must bring itself strictly within the terms of the statute and that any doubt is to be resolved in favor of the Government. If this be considered to be an exemption case, then the statement of Mr. Justice Cardozo in *Trotter v. Tennessee*, 290 U. S. 354 (1933), is most relevant. He said (p. 356):

> "Exemptions from taxation are not to be enlarged by implication if doubts are nicely balanced. *Chicago Theological Seminary v. Illinois*, 188 U. S. 662, 674. On the other hand, *they are not to be read so grudgingly as to thwart the purpose of the lawmakers.*" (Italics added.)

However, the question presented here is not an exemption in the true sense. The intendment of Congress was to lay a surtax on *undistributed* profits. *Helvering v. Northwest Steel Mills, supra*, and while in that case the court held that the taxpayer's claim under Section 26(c)(1) was for a credit in the matter of a specially permitted deduction and therefore to be strictly construed, it is significant that the sums there under consideration had not been distributed.

The sums under consideration here have been subject to the normal income tax and have been distributed. The broad issue is whether they are now subject to a further tax as "undistributed" in spite of the fact that they have been distributed pursuant to provisions of the trust indenture which "inevitably require in their performance a drawing on current earnings, thus removing current earnings as a source of dividend payments." *G. B. R. Oil Corporation, infra, Chesapeake Ferry Company, infra.*

In *G. B. R. Oil Corporation v. Commissioner*, 40 B. T. A. 738 (1939) the taxpayer, a corporation organized to develop and operate oil leases, borrowed money from a bank to use in the purchase of interests in oil leases. The bank was secured by deed of trust liens on the properties and also by assignments of the taxpayer's interests in the properties in trust, which assignments authorized the bank to receive and collect all sums of money derived from the properties and to apply the same on the indebtedness to the bank.

As a practical matter, because it was understood that the properties had to be operated and expenses paid, the bank credited the payments it received from the taxpayer's oil customers to the taxpayer's account, with an understanding that out of the funds deposited nothing would be paid of any character whatever except the actual, necessary and usual operating expenses, and the balance would be applied to the reduction of the loans. The taxpayer was also permitted to expend from the moneys thus deposited

considerable sums (about twenty-five thousand dollars) in development to increase production. The taxpayer's claim for a credit under Section 26(c)(2) of the Revenue Act of 1936 for all of the amounts paid to the bank in 1936 under this arrangement was allowed by the Board, which said in part at page 743 of 40 B. T. A.:

> "In determining whether the claimed credit of a corporate taxpayer falls within section 26(c)(2) and the regulations promulgated thereunder, three things seem to be necessary:
>
> "(1) There must be a written contract executed prior to May 1, 1936, which expressly deals with the disposition of earnings and profits of the taxable year.
>
> "(2) The credit relates to that portion of the earnings or profits which are required to be paid or irrevocably set aside in the discharge of a debt.
>
> "(3) The credit is allowable to the extent that the money has been so paid or set aside."

After determining that the taxpayer in the *G. B. R. Oil Corporation* case had met these conditions the Board, in holding that the credit should be granted, said at page 744 of 40 B. T. A.:

> "The general purpose of section 26(c)(2), it seems to us, is to give a credit where a dividend paid credit can not be secured. In other words, the basic intent of Congress seems to have been to include in the provision only contracts which inevitably require in their performance a drawing on current earnings, thus removing current earnings as a source of dividend payments. See *Paul and Mertens*, par. 32 A. 46, 1938 cumulative supplement.
>
> "Respondent in his brief cites no authority in support of his contention, but, after quoting the language of the assignments from petitioner to the bank, says:
>
> " 'We are unable to find in these contracts or assignments any provision which expressly deals with the disposition of petitioner's earnings and profits of the taxable year.'

"It is true, as we have already said, that the assignments in question do not expressly refer to 'earnings and profits' as such, but they certainly do require that all of petitioner's gross receipts from these properties be paid to the bank and that would certainly include all 'earnings and profits' from them.

"Respondent says in his brief that petitioner 'could have declared a dividend out of its earnings and profits of the taxable year and paid same with borrowed money, notes, credits, or in stock.' Perhaps it could have done so. We do not consider that is a matter which we have to decide. Even assuming that it is so, we do not see where that fact affects the application of the credit provided by section 26(c)(2). We sustain petitioner in this assignment of error.

"Reviewed by the Board."

In *Chesapeake Ferry Company v. Early, Jr., Collector*, ... F. Supp. ..., 39—2 U. S. T. C. § 9786, p. 10,923 (Dist. Ct. Va., 1939) the court at first denied a credit claimed under Section 26(c)(2) of the Revenue Act of 1936 for sinking fund payments made under a deed of trust. However, after the *G. B. R. Oil Corporation* case, *supra*, had been decided, the court filed an "Additional Memorandum" saying in part (p. 10,924):

"Upon re-hearing and re-consideration and in the light of the Board's decision, [in the *G. B. R. Oil* case] above quoted, I am of the opinion that the provisions of the deed of trust in question 'inevitably require in their performance a drawing on current earnings, thus removing current earnings as a source of dividend payments,' and that petitioner is entitled to the relief sought."

The sums paid by Warren Tool Corporation for the purchase of the bonds toward the close of each taxable year after the earnings for each year had been estimated are sums which, to the extent they represented twenty-five per cent of the net earnings of the taxpayer as finally determined, were irrevocably set aside pursuant to the provision

of a contract, the performance of which inevitably required a drawing on current earnings thus removing current earnings as a source of dividend payments.

CONCLUSION.

It is respectfully submitted that the decision of the Sixth Circuit Court of Appeals that there is no deficiency in the Surtax on Undistributed Profits for the taxable years 1936 and 1937 should be sustained.

RAYMOND T. JACKSON,
PAUL W. FRUM,
RAYMOND T. SAWYER, JR.,
C. SHERMAN DYE,
Attorneys for the Taxpayer.

BAKER, HOSTETLER & PATTERSON,
1956 Union Commerce Bldg.,
Cleveland, Ohio,
Of Counsel.

October 13, 1942.

APPENDIX A.

H. R. 12395 74th Congress 2nd Session.
As introduced in the House April 21, 1936.

SEC. 13. TAX ON CORPORATIONS.

(a) *Definitions.*—As used in this title—

(1) The term "adjusted net income" means the net income in excess of the credit provided in section 26 (relating to interest on certain obligations of the United States and Government corporations);

(2) The term "undistributed net income" means the adjusted net income minus the sum of—

(A) The dividend credit provided in section 27; and

(B) The tax computed under subsection (b).

(b) *Rate of Tax in General.*—There shall be levied, collected, and paid for each taxable year upon the adjusted net income of every corporation a tax as follows:

(1) *Adjusted Net Income $10,000 or Less.*—If the adjusted net income is not more than $10,000 the tax shall be computed under Schedule I or, at the option of the corporation, under Schedule IA (the tax being the same under both Schedules).

(2) *Adjusted Net Income More Than $10,000.*—If the adjusted net income is more than $10,000 the tax shall be computed under Schedule II or, at the option of the corporation, under Schedule IIA (the tax being the same under both Schedules); except that if the adjusted net income is less than $40,000 and if the tax would be less if computed under Schedule III, then the tax shall be computed under Schedule III.

SCHEDULE I—ADJUSTED NET INCOME OF $10,000 OR LESS BASED ON UNDISTRIBUTED NET INCOME

If the undistributed net income equals a percentage of the adjusted net income shown in column 1 of the following table, then the tax shall be the percentage of the adjusted net income shown opposite in column 2.

Column 1	Column 2	Column 1	Column 2	Column 1	Column 2
0	....	24	5.10	48	17.40
1	0.10	25	5.50	49	17.95
2	0.20	26	5.90	50	18.50
3	0.30	27	6.30	51	19.05
4	0.40	28	6.70	52	19.60
5	0.50	29	7.10	53	20.15
6	0.60	30	7.50	54	20.70
7	0.70	31	8.05	55	21.25
8	0.80	32	8.60	56	21.80
9	0.90	33	9.15	57	22.35
10	1.00	34	9.70	58	22.90
11	1.25	35	10.25	59	23.45
12	1.50	36	10.80	60	24.00
13	1.75	37	11.35	61	24.55
14	2.00	38	11.90	62	25.10
15	2.25	39	12.45	63	25.65
16	2.50	40	13.00	64	26.20
17	2.75	41	13.55	65	26.75
18	3.00	42	14.10	66	27.30
19	3.25	43	14.65	67	27.85
20	3.50	44	15.20	68	28.40
21	3.90	45	15.75	69	28.95
22	4.30	46	16.30	70	29.50
23	4.70	47	16.85		

If the undistributed net income is a percentage of the adjusted net income which is less than 10 (and such percentage is not shown in the foregoing table) the tax shall be a percentage of the adjusted net income equal to one-tenth of the percentage which the undistributed net income is of the adjusted net income.

If the undistributed net income is a percentage of the adjusted net income which is more than 10 and less than 20 (and such percentage is not shown in the foregoing table) the tax shall be a percentage of the adjusted net income equal to the sum of 1, plus one-fourth of the amount by which the percentage which the undistributed net income is of the adjusted net income exceeds 10.

If the undistributed net income is a percentage of the adjusted net income which is more than 20 and less than 30 (and such percentage is not shown in the foregoing

table) the tax shall be a percentage of the adjusted net income equal to the sum of 3.5, plus four-tenths of the amount by which the percentage which the undistributed net income is of the adjusted net income exceeds 20.

If the undistributed net income is a percentage of the adjusted net income which is more than 30 (and such percentage is not shown in the foregoing table) the tax shall be a percentage of the adjusted net income equal to the sum of 7.5, plus fifty-five one-hundredths of the amount by which the percentage which the undistributed net income is of the adjusted net income exceeds 30.

SCHEDULE IA—ADJUSTED NET INCOME OF $10,000 OR LESS BASED ON DIVIDEND CREDIT

If the dividend credit equals a percentage of the adjusted net income shown in column 1 of the following table, then the tax shall be the percentage of the adjusted net income shown opposite in column 2.

Column 1	*Column 2*	*Column 1*	*Column 2*	*Column 1*	*Column 2*
0	29.6774	40	15.4839	80	2.8000
..	.....	..	.....	..	.....
10	26.1290	50	11.9355	90	0.9091
..	.....	..	.....	..	.....
20	22.5806	60	8.3871	100	.....
..	.....	..	.....		
30	19.0323	70	5.3571		
..	.....	..	.....		

[NOTE: This schedule has been shortened by the indicated omissions and four paragraphs of text immediately following the schedule which paragraphs are "interpolators" similar in operation to those under Schedule I have also been omitted. The same omissions have been made under Schedules II and IIA.]

SCHEDULE II—ADJUSTED NET INCOME OF MORE THAN $10,000 BASED ON UNDISTRIBUTED NET INCOME

If the undistributed net income equals a percentage of the adjusted net income shown in column 1 of the following table, then the tax shall be the percentage of the adjusted net income shown opposite in column 2.

Column 1	Column 2	Column 1	Column 2	Column 1	Column 2
0	..	20	9.0	50	35.0
..	..	..	..	..	..
1	.4	30	15.0	57.5	42.5
..	..	..	..	..	..
10	4.0	40	25.0		
..	..	..	..		

[NOTE: See note under Schedule IA explaining omission of figures and "interpolators".]

If the undistributed net income is a percentage of the adjusted net income which is more than 30 (and such percentage is not shown in the foregoing table) the tax shall be a percentage of the adjusted net income equal to the sum of 15, plus the amount by which the percentage which the undistributed net income is of the adjusted net income exceeds 30.

Schedule IIA—Adjusted Net Income of More Than $10,000 Based on Dividend Credit.

If the dividend credit equals a percentage of the adjusted net income shown in column 1 of the following table, then the tax shall be the percentage of the adjusted net income shown opposite in column 2.

Column 1	Column 2	Column 1	Column 2	Column 1	Column 2
0	42.5	40	22.500	80	6.00000000
..	..	..	..	..	..
1	42.0	50	17.500	90	2.85714286
..	..	..	..	..	..
10	37.5	60	13.125	100	..
..	..	..	..		
20	32.5	70	9.3750		
..	..	..	..		
30	27.5	79	6.33333333		
..	..				

[NOTE: See note under Schedule IA explaining omission of figures and "interpolators".]

SCHEDULE III—ALTERNATIVE SCHEDULE FOR ADJUSTED NET INCOME OF MORE THAN $10,000 AND LESS THAN $40,000

If the adjusted net income is more than $10,000 and less than $40,000 the tax shall be computed by adding:

(A) A tax computed under Schedule I. For such purpose the percentage which the undistributed net income is of the adjusted net income shall be ascertained by subtracting from the adjusted net income the dividend credit and a tax determined under Schedule II or IIA; and

(B) A tax upon the amount of the adjusted net income in excess of $10,000 at the rate which would be applied if the tax upon the entire adjusted net income were being computed under Schedule II. For such purpose the percentage which the undistributed net income is of the adjusted net income shall be ascertained by subtracting from the adjusted net income the dividend credit and a tax determined under Schedule II or IIA.

(c) *Exempt Corporations.*—For corporations exempt from tax, see section 101.

(d) *Banks and Trust Companies.*—For taxation of certain banks and trust companies, see section 104.

(e) *Receiverships.*—For taxation of domestic corporations in receivership, see section 105.

(f) *Improper Accumulation of Surplus.*—For surtax on corporations which accumulate surplus to avoid surtax on stockholders, see section 102.

SEC. 14. ACCUMULATED EARNINGS AND PROFITS LESS THAN ADJUSTED NET INCOME.

(a) *General Rule.*—If the accumulated earnings and profits of the corporation as of the close of the taxable year (computed without diminution by reason of the distribution during the taxable year of earnings and profits, or by reason of the taxes imposed by this title for the taxable year) are less than the adjusted net income, the tax imposed by section 13 shall, in lieu of being computed under section 13, be computed by adding:

(1) A tax of 22½ per centum of the excess of the adjusted net income over such accumulated earnings and profits; and

(2) A tax upon the remainder of the adjusted net income (less the tax under paragraph (1)) computed under section 13 as if the adjusted net income were equal to the amount of such remainder so reduced.

(b) *Tax Not To Be Increased.*—This section shall not be applied in any case in which such application would operate to increase the tax which would be payable without its application.

SEC. 15. CONTRACTS NOT TO PAY DIVIDENDS.

(a) *General Rule.*—If under a written contract executed by the corporation prior to March 3, 1936, there is no form in which dividends equal to the adjusted net income for the taxable year may be paid during the dividend year without violating a provision of such contract expressly dealing with the payment of dividends, the tax imposed by section 13 shall, in lieu of being computed under such section, be computed by adding:

(1) A tax of 22% per centum of the excess of the adjusted net income over the amount which is not prohibited during the whole of the dividend year from being paid as dividends during the dividend year; and

(2) A tax upon the remainder of the adjusted net income (less the tax under paragraph (1)) computed under section 13 as if the adjusted net income were equal to the amount of such remainder so reduced.

(b) *Tax not to be Increased.*—This section shall not be applied in any case in which such application would operate to increase the tax which would be payable without its application.

SEC. 16. DEBTS.

(a) *Definition of "Debt."*—As used in this section the term "debt" means an indebtedness of the corporation existing at the close of business on March 3, 1936, and evi-

denced by a bond, note, debenture, certificate of indebtedness, mortgage, or deed of trust, issued by the corporation and in existence of the close of business on March 3, 1936, or by a bill of exchange accepted by the corporation prior to, and in existence at, the close of business on such date; to the following extent:

(1) If having a maturity at the time of issue of three years or more, then to the full amount thereof;

(2) If having a maturity at the time of issue of less than three years, then to the extent shown to the satisfaction of the Commissioner (whose decision shall be final) to represent indebtedness incurred by the corporation prior to March 4, 1933; or

(3) If having a maturity at the time of issue of less than three years, then to the extent shown to the satisfaction of the Commissioner (whose decision shall be final) to evidence indebtedness of the corporation incurred in the acquisition of capital assets, except (A) shares of stock in any corporation, or (B) rights to subscribe for or to receive such shares, or (C) bonds, debentures, notes, or certificates or other evidences of indebtedness, issued by any corporation, with interest coupons or in registered form, or (D) certificates of profit, or of interest in property or accumulations, in any investment trust or similar organization holding or dealing in any of the instruments mentioned or described in this paragraph, regardless of whether or not such investment trust or similar organization constitutes a corporation within the meaning of this Act.

(b) *Computation of Tax.*—If the sum of all the debts computed under subsection (a) of this section is in excess of the accumulated earnings and profits of the corporation as of the day before the first day of its first taxable year beginning after December 31, 1935, and if the corporation, in its return for its first taxable year under this title, specifies the number of consecutive taxable years (not less than five) over which such debt excess shall be amortized for the purposes of this subsection, then for such number of consecutive taxable years, beginning with the first taxable year of the corporation under this title (or if no such specification is made, then for the first ten taxable years)

the tax imposed by section 13, in lieu of being computed under such section, shall be computed by adding:

(1) A tax of 22½ per centum of an amount of the adjusted net income equal to the amount of such debt excess divided by the number of years so specified (or, if no specification, then by ten); and

(2) A tax upon the remainder of the adjusted net income (less the tax under paragraph (1)) computed under section 13 as if the adjusted net income were equal to the amount of such remainder so reduced.

(c) *Tax Not to be Increased.*—This section shall not be applied in any case in which such application would operate to increase the tax which would be payable without its application.

(d) *List of Evidences of Indebtedness.*—Every corporation shall accompany its return for its first taxable year under this title with an itemized list (prepared in accordance with regulations prescribed by the Commissioner, with the approval of the Secretary) of the bonds, notes, and other instruments which it claims evidence indebtedness coming within the meaning of the term "debt" as defined in subsection (a). For the purposes of this section no debt shall be included in computing debts under section (a) unless the instrument evidencing such debt is included in such list.

SEC. 17. APPLICATION OF SECTIONS 14, 15, AND 16 TO SAME TAXABLE YEAR.

If in the case of any corporation more than one of sections 14, 15, and 16 are applicable, the tax shall be computed under the one of such sections which will produce the least tax.

SEC. 27. CORPORATION CREDIT FOR DIVIDENDS PAID.

(a) *Definition of "Dividend Year."*—The term "dividend year," when used in this title with reference to a corporation, means the period beginning on the fifteenth day of the third month after the day before the beginning of the taxable year (whether the taxable year is a period of

twelve months or a shorter period) and ending on the fourteenth day of the third month after the close of the taxable year.

(b) *Dividend Credit in General.*—For the purposes of this title, the dividend credit shall be the amount of dividends paid during the dividend year corresponding to the taxable year.

(c) *Dividend Carry-Over.*—In computing the dividend credit for any taxable year, if the dividends paid during the dividend year are less than the adjusted net income, there shall be allowed as part of the dividend credit, and in the following order:

(1) Dividends paid during the second preceding dividend year in excess of the adjusted net income for the corresponding taxable year, to the extent not needed as a dividend credit for the taxable year preceding the taxable year the tax for which is being computed; and

(2) Dividends paid during the first preceding dividend year in excess of the adjusted net income for the corresponding taxable year.

In the case of a taxable year the tax for which has been or is being computed under section 14 or 15 the term "adjusted net income" as used in this subsection means the amount subject to tax under subsection (a) (2) of such section; and in case of a taxable year the tax for which has been or is being computed under section 16 the term "adjusted net income" as used in this subsection means the amount subject to tax under subsection (b) (2) of such section. No credit shall be allowed for dividends paid by a corporation prior to the 15th day of the third month of its first taxable year under this title.

(d) *Dividends in Kind.*—If a dividend is paid in property other than money (including stock of the corporation if held by the corporation as an investment) the dividend credit with respect thereto shall be the adjusted basis of the property in the hands of the corporation at the time of the payment, or the fair market value of the property at the time of the payment, whichever is the lower.

(e) *Dividends in Obligations of the Corporation.*—If a dividend is paid in obligations of the corporation, the amount of the dividend credit with respect thereto shall be the face value of the obligations, or their fair market value at the time of the payment, whichever is the lower. If the fair market value is lower than the face value, then when the obligation is redeemed by the corporation, the excess of the amount for which redeemed over the fair market value at the time of the dividend payment (to the extent not allowable as a deduction in computing net income for any taxable year) shall be treated as a dividend paid in the dividend year in which the redemption occurs.

(f) *Taxable Stock Dividends.*—In case of a stock dividend or stock right which is a taxable dividend in the hands of shareholders under section 115 (f), the dividend credit with respect thereto shall be the fair market value of the stock or the stock right at the time of the payment.

(g) *Distributions in Liquidation.*—In the case of amounts distributed in liquidation the part of such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913, shall, for the purposes of computing the dividend credit under this section, be treated as a taxable dividend paid.

(h) *Preferential Dividends.*—No dividend credit shall be allowed with respect to any distribution unless the distribution is pro rata, equal in amount, and with no preference to any share of stock as compared with other shares of the same class, and each of the shareholders of that class, who are subject to taxation under this title for the period in which the distribution is made, receives a taxable dividend as a result of the distribution.

(i) *Nontaxable Distributions.*—If any part of a distribution (including stock dividends and stock rights) is not a taxable dividend in the hands of such of the shareholders as are subject to taxation under this title for the period in which the distribution is made, no dividend credit shall be allowed with respect to such part.

(j) *Intercorporate Dividends.*—If 80 per centum or more of the gross income of the corporation is derived from dividends, then the dividend credit with respect to

each dividend payment shall be reduced to an amount equal to the sum of:

(1) The portion of such dividend payment paid to shareholders other than corporations;

(2) The portion of such dividend payment paid to corporations taxable under section 104, 105, 201, 204, 207, 231, 251, or 261, or to corporations exempt from taxation under section 101;

(3) The portion of such dividend payment made to a corporate shareholder owning less than 50 per centum of the class of stock with respect to which the dividend is paid; and

(4) An amount of such dividend payment paid to other corporate shareholders which bears the same ratio to the total dividend payment paid to them as the part of the gross income not derived from dividends bears to the entire gross income.

APPENDIX B.

House Amendments to H. R. 12395 as Passed by the House April 29, 1936.

SEC. 14. ACCUMULATED EARNINGS AND PROFITS LESS THAN ADJUSTED NET INCOME.

Sec. 14 (a) (1) relating to special tax where corporation has a deficit, is amended by changing the rate from 22½ per cent to 15 per cent so that it reads as follows:

(1) A tax of 15 per centum of the excess of the adjusted net income over such accumulated earnings and profits; and

SEC. 15. CONTRACTS NOT TO PAY DIVIDENDS.

Subsection (a) and subdivision (1) thereof of Sec. 15 are amended by changing "dividend year" to "taxable year" so that the subsection reads as follows:

(a) *General Rule.*—If under a written contract executed by the corporation prior to March 3, 1936, there is no form in which dividends equal to the adjusted net income for the taxable year may be paid during the taxable year without violating a provision of such contract expressly dealing with the payment of dividends, the tax imposed by section 13 shall, in lieu of being computed under such section, be computed by adding:

(1) A tax of 22½ per centum of the excess of the adjusted net income over the amount which is not prohibited during the whole of the taxable year from being paid as dividends during the taxable year; and

SEC. 27. CORPORATION CREDIT FOR DIVIDENDS PAID.

(a) *Dividend Credit in General.*—For the purposes of this title, the dividend credit shall be the amount of dividends paid during the taxable year.

(b) *Dividend Carry-Over.*—In computing the dividend credit for any taxable year, if the dividends paid during the taxable year are less than the adjusted net income, there shall be allowed as part of the dividend credit, and in the following order:

(1) Dividends paid during the second preceding taxable year in excess of the adjusted net income for such year, to the extent not needed as a dividend credit for the taxable year preceding the taxable year the tax for which is being computed; and

(2) Dividends paid during the first preceding taxable year in excess of the adjusted net income for such year.

In the case of a taxable year the tax for which has been or is being computed under section 14 or 15 the term "adjusted net income" as used in this subsection means the amount subject to tax under subsection (a) (2) of such section; and in case of a taxable year the tax for which has been or is being computed under section 16 the term "adjusted net income" as used in this subsection means the amount subject to tax under subsection (b) (2) of such section. No credit shall be allowed for dividends paid by a corporation prior to its first taxable year under this title.

(c) *Dividends in Kind.*—If a dividend is paid in property other than money (including stock of the corporation if held by the corporation as an investment) the dividend credit with respect thereto shall be the adjusted basis of the property in the hands of the corporation at the time of the payment, or the fair market value of the property at the time of the payment, whichever is the lower.

(d) *Dividends in Obligations of the Corporation.*—If a dividend is paid in obligations of the corporation, the amount of the dividend credit with respect thereto shall be the face value of the obligations, or their fair market value at the time of the payment, whichever is the lower. If the fair market value is lower than the face value, then when the obligation is redeemed by the corporation, the excess of the amount for which redeemed over the fair market value at the time of the dividend payment (to the extent not allowable as a deduction in computing net income for any taxable year) shall be treated as a dividend paid in the taxable year in which the redemption occurs.

[No amendments (except the relettering) were made to the newly relettered subsections (e) to (i).]

APPENDIX C.

H. R. 12395 as Reported to the Senate June 1, 1936.

SEC. 13. NORMAL TAX ON CORPORATIONS.

(a) *Definition.*—As used in this title the term "normal-tax net income" means the net income minus the sum of—

(1) *Interest on obligations of the United States and its instrumentalities.*—The credit provided in section 26 (a).

(2) *Dividends received.*—The credit provided in section 26 (b).

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the normal-tax net income of every corporation, a normal tax as follows:

Upon normal-tax net incomes not in excess of $2,000, 15½ per centum.

$310 upon normal-tax net incomes of $2,000; and upon normal-tax net incomes in excess of $2,000 and not in excess of $15,000, 16 per centum in addition of such excess.

$2,390 upon normal-tax net incomes of $15,000; and upon normal-tax net incomes in excess of $15,000 and not in excess of $40,000, 17 per centum in addition of such excess.

$6,640 upon normal-tax net incomes of $40,000; and upon normal-tax net incomes in excess of $40,000, 18 per centum in addition of such excess.

(c) *Exempt Corporations.*—For corporations exempt from taxation under this title, see section 101.

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) *Definitions.*—As used in this title—

(1) The term "adjusted net income" means the net income minus the sum of—

(A) The normal tax imposed by section 13.

(B) The credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

(C) In the case of a holding company affiliate (as defined in section 2 of the Banking Act of 1933), the amount allowed as a credit under section 26 (d).

(2) The term "undistributed net income" means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts not to pay dividends.

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax of 7 per centum of the amount of the undistributed net income.

(c) *Exemption From Surtax.*—The following corporations shall not be subject to the surtax imposed by this section:

(1) Banks. As used in this paragraph the term "bank" means a bank or trust company incorporated and doing business under the laws of the United States (including laws relating to the District of Columbia), of any State, or of any Territory, a substantial part of the business of which consists of receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted to national banks under section 11 (k) of the Federal Reserve Act, as amended, and which is subject by law to supervision and examination by State or Federal authority having supervision over banking institutions.

(2) Domestic corporations which for any portion of the taxable year are in bankruptcy under the laws of the United States, or are insolvent and in receivership in any court of the United States or of any State, Territory, or the District of Columbia.

(3) Insurance companies subject to the tax imposed under section 201, 204, or 207.

(4) Foreign corporations.

(5) Corporations which, by reason of deriving a large portion of their gross income from sources within a possession of the United States, are subject to the tax imposed under section 251.

(6) Corporations organized under the China Trade Act, 1922.

(d) *Exempt Corporations.*—For corporations exempt from taxation under this title, see section 101.

(e) *Tax on Personal Holding Companies.*—For surtax on personal holding companies, see section 351.

(f) *Improper Accumulation of Surplus.*—For surtax on corporations which accumulate surplus to avoid surtax on stockholders, see section 102.

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

(a) *Interest on Obligations of the United States and Its Instrumentalities.*—The amount received as interest upon obligations of the United States or of corporations organized under Act of Congress which is allowed to an individual as a credit for purposes of normal tax by section 25 (a) (1) or (2).

(b) *Dividends Received.*—90 per centum of the amount received as dividends from a domestic corporation which is subject to taxation under this title. The credit allowed by this subsection shall not be allowed in respect of dividends received from a corporation organized under the China Trade Act, 1922, or from a corporation which under section 251 is taxable only on its gross income from sources within the United States by reason of its receiving a large percentage of its gross income from sources within a possession of the United States.

(c) *Contracts Not to Pay Dividends.*—The amount by which the adjusted net income exceeds the amount which during the whole of the taxable year is not prohibited by a contract from being paid as dividends during the taxable year. As used in this subsection, the term "contract" means a written contract executed by the corporation prior to March 3, 1936, under which there is no form in which dividends equal to the adjusted net income for the taxable year may be paid during the taxable year without violating a provision of such contract expressly dealing with the payment of dividends.

(d) *Bank Affiliates.*—In the case of a holding company affiliate (as defined in section 2 of the Banking Act of 1933), the amount of the earnings or profits which the Board of Governors of the Federal Reserve System certifies to the

Commissioner has been devoted by such affiliate during the taxable year to the acquisition of readily marketable assets other than bank stock in compliance with section 5144 of the Revised Statutes, but the aggregate amount allowable under this subsection for all taxable years shall not exceed the amount required to be devoted under such section to such purposes.

SEC. 27. CORPORATION CREDIT FOR DIVIDENDS PAID.

(a) *Dividends Paid Credit in General.*—For the purposes of this title, the dividends paid credit shall be the amount of dividends paid during the taxable year.

(b) *Dividend Carry-Over.*—In computing the dividends paid credit for any taxable year, if the dividends paid during the taxable year are less than the adjusted net income, there shall be allowed as part of the dividends paid credit, and in the following order:

(1) Dividends paid during the second preceding taxable year in excess of the adjusted net income for such year, to the extent not needed as a dividends paid credit for the taxable year preceding the taxable year the tax for which is being computed; and

(2) Dividends paid during the first preceding taxable year in excess of the adjusted net income for such year.

No credit shall be allowed for dividends paid by a corporation prior to its first taxable year under this title.

(c) *Dividends in Kind.*—If a dividend is paid in property other than money (including stock of the corporation if held by the corporation as an investment) the dividends paid credit with respect thereto shall be the adjusted basis of the property in the hands of the corporation at the time of the payment, or the fair market value of the property at the time of the payment, whichever is the lower.

(d) *Dividends in Obligations of the Corporation.*—If a dividend is paid in obligations of the corporation, the amount of the dividends paid credit with respect thereto shall be the face value of the obligations, or their fair market value at the time of the payment, whichever is the lower. If the fair market value is lower than the face value, then when the obligation is redeemed by the corpora-

tion, the excess of the amount for which redeemed over the fair market value at the time of the dividend payment (to the extent not allowable as a deduction in computing net income for any taxable year) shall be treated as a dividend paid in the taxable year in which the redemption occurs.

(e) *Taxable Stock Dividends.*—In case of a stock dividend or stock right which is a taxable dividend in the hands of shareholders under section 115 (f), the dividends paid credit with respect thereto shall be the fair market value of the stock or the stock right at the time of the payment.

(f) *Distributions in Liquidation.*—In the case of amounts distributed in liquidation the part of such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913, shall, for the purposes of computing the dividends paid credit under this section, be treated as a taxable dividend paid.

(g) *Preferential Dividends.*—No dividends paid credit shall be allowed with respect to any distribution unless the distribution is pro rata, equal in amount, and with no preference to any share of stock as compared with other shares of the same class.

(h) *Nontaxable Distributions.*—If any part of a distribution (including stock dividends and stock rights) is not a taxable dividend in the hands of such of the shareholders as are subject to taxation under this title for the period in which the distribution is made, no dividends paid credit shall be allowed with respect to such part.

APPENDIX D.

Senate Amendments to H. R. 12395 as passed by the Senate June 5, 1936.

SEC. 13. NORMAL TAX ON CORPORATIONS.

(a) *Definition.*—As used in this title the term "normal-tax net income" means the net income minus the sum of—

(1) Interest on obligations of the United States and its instrumentalities.—The credit provided in section 26 (a).

(2) Dividends received.—The credit provided in section 26 (b).

(3) Dividends paid.—In the case of mutual investment companies the credit provided in section 27.

[(b)-(c). Unchanged from Senate Committee Bill.]

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

[(a)-(b). Unchanged from Senate Committee Bill.]

(c) *Exemption From Surtax.*—The following corporations shall not be subject to the surtax imposed by this section:

(1) Banks. As used in this paragraph the term "bank" means a bank, or a banking institution engaged only in a business similar to that transacted by Morris Plan banks, or a trust company, incorporated and doing business under the laws of the United States (including laws relating to the District of Columbia), of any State, or of any Territory, a substantial part of the business of which consists of receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted to national banks under section 11 (k) of the Federal Reserve Act, as amended, and which is subject by law to supervision and examination by State or Federal authority having supervision over banking institutions.

[(2)-(6). Unchanged from Senate Committee Bill.]

[(d)-(i). Unchanged from Senate Committee Bill.]

[Secs. 21-25. Unchanged from Senate Committee Bill.]

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

[(a). Unchanged from Senate Committee Bill.]

(b) *Dividends Received.*—90 per centum of the amount received as dividends from a domestic corporation which is subject to taxation under this title. The credit allowed by this subsection shall not be allowed in respect of dividends received from a corporation organized under the China Trade Act, 1922, or from a corporation which under section 251 is taxable only on its gross income from sources within the United States by reason of its receiving a large percentage of its gross income from sources within a possession of the United States. The credit allowed by this subsection shall not be allowed to mutual investment companies. (For definition of mutual investment company, see section 1001.)

(c) *Contracts Restricting Payment of Dividends.*—

(1) Prohibition on payment of dividends.—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

(2) Disposition of profits of taxable year.—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such

amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

(3) Double credit not allowed.—If both paragraph (1) and paragraph (2) apply, the one of such paragraphs which allows the greater credit shall be applied; and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.

[(d). Unchanged from Senate Committee Bill.]

SUPREME COURT OF THE UNITED STATES.

Nos. 40, 41, and 42.—October Term, 1942.

Helvering, Commissioner of Internal Revenue, Petitioner,
40 *vs.*
The Ohio Leather Company.

Helvering, Commissioner of Internal Revenue, Petitioner,
41 *vs.*
The Strong Manufacturing Company.

Helvering, Commissioner of Internal Revenue, Petitioner,
42 *vs.*
Warren Tool Corporation.

On Writs of Certiorari to the United States Circuit Court of Appeals for the Sixth Circuit.

[November 9, 1942.]

Mr. Justice Murphy delivered the opinion of the Court.

The issue is whether respondents are entitled to certain claimed credits against their undistributed profits tax for the 1936 taxable year[1] by virtue of § 26(c)(2) of the Revenue Act of 1936, 49 Stat. 1648.[2]

In each of these cases the taxpayer corporation contracted prior to May 1, 1936, by a written agreement to apply a per-

[1] Taxpayer in No. 42 is also claiming a credit for the 1937 taxable year.

[2] Sec. 26. Credits of Corporations.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

. . . . . .

(c) *Contracts Restricting Payment of Dividends.*—

. . . . . .

(2) *Disposition of Profits of Taxable Year.*—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt, to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside

centage of its net earnings of a particular calendar year to an indebtedness of the corporation; in each case the agreement expressly provided only that the payment of the specified percentage was to be made on or before a certain date—April 1 in the case of The Ohio Leather Company and Warren Tool Corporation and April 15 in the case of The Strong Manufacturing Company—in the year following the calendar year during which the net earnings arose.[3] However, the specified percentage was actually paid during the taxable year in each case. By reason

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an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

[3] The relevant contractual provisions in each case are as follows:

No. 40.

By an indenture entered into on April 17, 1936, The Ohio Leather Company covenanted to pay $25,000 annually to a trustee to create a sinking fund for the security of its debentures, and further covenanted that it would "on or before the next succeeding first day of April, pay an amount equal to ten per cent (10%) of the net earnings earned by the Company during the fiscal year ending on the thirty-first day of the next preceding December, as such net earnings are defined hereinafter in the Article, which sums and amounts shall by held by the Trustee for the security of all outstanding Debentures until paid out as hereinafter provided."

No. 41.

By a note and mortgage agreement executed April 15, 1932, The Strong Manufacturing Company bound itself to apply forty per centum of its net earnings upon its unpaid obligation. The mortgage provided:

"The Company covenants and agrees that until the principal and interest of the note hereby secured shall have been fully paid and beginning on January 1st, One Thousand nine hundred thirty four, the Company will apply forty per centum (40%) per annum of its net earnings for any calendar year in payment of the interest accruing and becoming payable upon such note in such year, and the balance of the principal amount of such note unpaid prior to April 15th in such year; provided, however, that the covenant herein made shall not be construed to relieve the Company from the payment on April 15th in such year of the installment specified for payment by the terms of said note nor of the regular interest payments in such year, likewise as specified in said note.

. . . . . .

Settlement for all amounts becoming payable under this provision in excess of the principal and interest payments absolutely required in the calendar year as of which such net earnings are determined shall be made by the Company to the Bank not later than April 15th of the succeeding year."

No. 42.

On November 1, 1932, the Warren Tool Corporation executed a first mortgage and deed of trust to secure a bond issue. The mortgage contained a sinking fund provision which required the Corporation on and after April 1, 1935, to pay to the trustee "on or before the 1st day of April of each year thereafter to and including April 1, 1942, a sum of money equal to Twenty-five Per Cent (25%) of its net earnings for the calendar year next preceding."

of these contracts and payments, taxpayers have sought to avail themselves of the credit authorized by § 26(c)(2), which relieves from the tax on undistributed profits, imposed by § 14 of the 1936 Act, any profits which may not be distributed because of a contract requiring that a portion of earnings of the taxable year be paid or irrevocably set aside within the taxable year for the discharge of a debt. The Commissioner of Internal Revenue determined that the credits claimed should not be allowed, and assessed deficiencies in each case. The Board of Tax Appeals overruled the Commissioner, and the Circuit Court of Appeals affirmed.[4] We granted certiorari because of an asserted conflict with *Antietam Hotel Corp.* v. *Commissioner*, 123 F. 2d 274.[5]

Since § 26(c)(2) grants a special credit in the nature of a deduction, the taxpayer must sustain the burden of showing compliance with its exact terms. *Helvering* v. *Northwest Steel Mills*, 311 U. S. 46, 49; *White* v. *United States*, 305 U. S. 281, 292; *New Colonial Ice Co.* v. *Helvering*, 292 U. S. 435, 440. We agree with the Commissioner that taxpayers have not carried that burden.

Section 26(c)(2) expressly sets up three specific conditions precedent with which a corporation devoting part of its earnings to the payment of debts rather than the payment of dividends must comply before it is entitled to relief from the tax on undistributed profits—(1) there must be a written contract executed by the corporation prior to May 1, 1936; (2) this contract must contain a provision expressly dealing with the disposition of earnings and profits of the taxable year; and, (3) this contract must contain a provision requiring that a portion of such earnings and profits either (a) "be paid within the taxable year in discharge of a debt", or (b) "be irrevocably set aside within the taxable year for the discharge of a debt". A taxpayer whose contract satisfies each of these three requirements is entitled to a credit to the extent of the amount which has been so paid or irrevocably set aside.

While taxpayers have met the first two statutory requirements —the written contracts antedate May 1, 1936, and contain provisions expressly dealing with the disposition of earnings for the taxable year—, they have not met the third one.[6] The con-

[4] An opinion was written only in Commissioner v. Strong Mfg. Co., 124 F. 2d 360. The other two cases were per curiam affirmances on the authority of that opinion. 124 F. 2d 397.

[5] Compare Helvering v. Moloney Electric Co., 120 F. 2d 617, 621.

tracts clearly contain no provision requiring the payment of earnings "within the taxable year in discharge of a debt". Nor do they, contrary to taxpayers' assertion, require the irrevocable setting aside of earnings "within the taxable year for the discharge of a debt" within the meaning of § 26(c)(2). The contracts are wholly silent in respect of any setting aside; they do not in terms require taxpayers to set aside the amount due, nor do they direct any segregation or physical retention whatsoever. The only requirement is that taxpayers pay on or before a date *after* the close of the taxable year. This is not enough. Until that date taxpayers were free to use the specified percentages as they pleased, so far as the agreements were concerned. That prudent business judgment, or the possibility of fiduciary liability imposed by operation of law might have constrained taxpayers to refrain from using these percentages and actually to set them aside is immaterial; such setting aside was not required by the terms of the written contracts, and therefore did not satisfy § 26(c)(2). Cf. *Helvering* v. *Northwest Steel Mills*, 311 U. S. 46, 52. Likewise the fact that taxpayers actually irrevocably set the funds aside by anticipatory payments within the taxable year is of no moment, because these payments were voluntary and not pursuant to the command of the agreements.

That Congress did not intend that the statutory condition of an irrevocable setting aside would be satisfied by a contract which, without more, merely requires that a percentage of earnings of the taxable year be paid in some future year for the discharge of a debt, is evident because such a construction reduces the alternative condition of § 26(c)(2) relating to actual payment within the taxable year to a meaningless superfluity. The date specified for payment would become immaterial for all purposes if the mere requirement by contract of future payment out of earnings in a given year automatically entails an "irrevocable setting aside" within that year.

Taxpayers here place great emphasis upon the different prepositions used in the alternative phrases—"to be paid within the taxable year *in* discharge of a debt" or to be irrevocably set aside

[6] This holding makes it unnecessary to consider the Commissioner's contention that The Strong Manufacturing Company did not meet the second requirement as to $5,000 of the $46,500 paid in 1936, because it was obligated to pay that sum by April 15, 1937, even in the event that there were no earnings in 1936.

within the taxable year *for* the discharge of a debt''— to show that payment may be made after the taxable year compatibly with § 26(c)(2). True enough, payment can be postponed to a future year and a credit allowed if, but only if, the contract directing such future payments requires in terms the irrevocable setting aside within the taxable year of those future payments. The instant contracts do not so provide.

Respondents, The Ohio Leather Company and Warren Tool Corporation, contend that because they were on an accrual basis of accounting, they were entitled to the credit by virtue of § 43[7] which states that it is to be disregarded in computing the credit provided by § 27 and makes no statement with regard to § 26. The contention is without merit because principles of accrual accounting have no bearing on the question of whether a contract in terms requires a payment or an irrevocable setting aside within the taxable year. The question here is not whether taxpayers made payment, either on a cash or an accrual basis, within the taxable year, but whether their contracts required them to pay or irrevocably set aside within the taxable year.

Taxpayers insist that it would be unreasonable to hold that only contracts expressly requiring payment or an irrevocable setting aside of a percentage of earnings within the taxable year satisfy § 26(c)(2) because many corporations are unable to determine their earnings until after the close of their fiscal year, and consequently their contracts disposing of a percentage of earnings in satisfaction of debt customarily allow some short period after the close of the year before payment is required. The legislative history of the 1936 Act reveals that Congress was conversant with the problem of computing earnings before the end of the taxable year, in connection with dividend payments, but declined to act.[8] Corporations with oral contracts, or written contracts executed after May 1, 1936, dealing with the disposition of profits in satisfaction of debts also probably think § 26(c)(2) is a most unreasonable statute. But arguments urging the broadening of a tax deduction statute beyond its plain mean-

[7] Sec. 43. Period for Which Deductions and Credits Taken.
The deductions and credits (other than the dividends paid credit provided in section 27) provided for in this title shall be taken for the taxable year in which ''paid or accrued'' or ''paid or incurred'', dependent upon the method of accounting upon the basis of which the net income is computed, ...''

[8] The original House bill (H. R. 12395, 74th Cong., 2d Sess., introduced at 80 Cong. Rec. 5978) provided for the use of the ''dividend year'' in com-

ing to avoid harsh results are more properly addressed to Congress than to the courts. *White* v. *United States*, 305 U. S. 281, 292.[9]

Finally taxpayers contend that the legislative history of § 26(c)(2) supports the view that their contracts are covered by that section. An examination of the entire legislative background of the undistributed profits tax demonstrates, contrary to taxpayers' contentions, that Congress intended the tax to be imposed primarily upon income not distributed in the form of dividends, rather than only upon corporate income which was not distributed at all and accordingly meant to limit severely credits for a corporation's payment of debts and precisely to define the area in which taxpayers were to be entitled to the credit. Thus, while the original House bill contained complicated provisions affording some relief to corporations with deficits, or contractually obligated either to pay debts or not to pay dividends, the Senate Finance Committee struck them all out, substituting only a provision dealing with a credit for contractual prohibitions against the payment of dividends.[10] An amendment offered from the Senate floor giving a broad credit for all portions of adjusted net income used to purchase or replace machinery, equipment, etc., or "expended or applied during the taxable year for the liquidation, payment, or reduction of the principal of any bona-fide indebtedness outstanding at the date of enactment of this Act" was rejected.[11]

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puting undistributed net income under § 13, and dividend credit under § 15. Section 27 defined "dividend year" as the period beginning on the 15th day of the third month after the day before the beginning of the taxable year and ending on the 14th day of the third month after the close of the taxable year. Thus, where the calendar year and the taxable year coincided, the "dividend year" would cover the period from March 15 of the taxable year to March 14 of the following year. Congressman Hill, chairman of the subcommittee of the House Ways and Means Committee, explained that the "dividend year" was designed to allow corporations time to cast up their accounts after the close of the taxable year and then determine what dividends should be distributed. 80 Cong. Rec. 6005. Nevertheless, Congressman Hill later offered, and the House adopted, a committee amendment substituting the "taxable year" for the "dividend year". 80 Cong. Rec. 6308. See also 80 Cong. Rec. 10265.

[9] Appeals to Congress because of the limited scope of § 26(c)(2) were successful in 1938. Section 27(a)(4) of the Revenue Act of 1938 allows a credit without reference to the particular terms or requirements of the indebtedness. See H. Rep. No. 1860, 75th Cong., 3d Sess., p. 4.

[10] This legislative history is discussed in Helvering v. Northwest Steel Mills, 311 U. S. 46, 50.

[11] 80 Cong. Rec. 9055, 9070, 74th Cong., 2d Sess.

The much narrower amendment which became §.26(c)(2) was then offered with little explanation other than that it was intended to supplement the credit for contractual prohibition against dividend payments, the provision which became § 26(c)(1).[12]

We conclude that the judgments below were erroneous. Accordingly they are reversed, and the causes remanded with directions to uphold the determination of the Commissioner.

Reversed.

A true copy.

Test:

Clerk, Supreme Court, U. S.

[12] 80 Cong. Rec. 9071, 74th Cong., 2d Sess.